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How to make financial institutions more resilient in current global financial system?

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1. Introduction

In recent times, the global financial system has become less regulated and integrated as it was ever before; with institutions involved having far more reach in their operations, activities and functions they perform as compared previously (Berger et al., 2000; Schmukler & Abraham, 2017; Giddens, 2018). As financial markets become more liberalized; majorly due to Glass-Steagall Act of 1933 which expanded banks power functionally and geographically and then in 1999 the Gramm-Leach-Bliley Financial Services Modernization Act, which expanded banks securities power along with their ability to enter insurance and other financial services businesses. Now trading of stocks, bonds, swaps, futures and other financial instruments happening 24/7 across globe; the institutes involved in trading of these instruments have become large and complex. These Large Complex Financial Institutes (LCFI's) include commercial banks, Investment banks, asset management companies and Insurance companies (Saunders et al., 2009). On one hand this has reduced transaction costs and made financial markets more uniform but on the other hand; it has also increased risk of these LCFI's; (Lane et al., 2018). To manage these financial institutions in the globalized financial system it is important that their resilience (ability to recover quickly after difficulty) and stability must be ensured (Wei, 2018).

This essay elaborates on the premises of making financial institutions more resilient in the current global financial system, as past crisis have shown that how financial trouble in one region (East Asian Crisis and European Crisis) or country (US Subprime Mortgage Crisis) can have a long term consequences at macro and micro economic level (Reinhart & Rogoff, 2015; Stiglitz, 2000). It also focuses on how different financial institutions such as IMF, World Bank and other G-20 countries can contribute in managing the crisis (Schüller and Wogart, 2017). The essay also focuses on the management of Systemically Important Financial Institutions (SIFI's), elaborating on managing systemic risk associated with such institutions (Bongini et al., 2015; Dacorogna and Busse, 2017).

2. Why resilience matter?

History is plagued with examples of various financial crises that jolted the entire global financial system; such crises are amongst the core reason why the financial institutions need to be resilient in the current dynamic financial system (Jackson, 2018; Hein, 2016; Claessens et al., 2014). After the recession of 1930's, the world was in severe liquidity crunch and oil rich countries were loaded with money as oil prices increased. In 1970's – 80's debt crisis emerged in Latin America where, Mexico and Brazil took private bank loans from oil rich countries; the loans were made on future oil prices so when they crashed so does the Mexican economy. Mexico announced that they will not be able to meet their debt obligation resulting in major cuts in their loan funding.

Another crisis was the East Asian crisis where, the economies of Thailand, Indonesia and Korea were hit the most. These economies before crisis had high saving rates, low unemployment rates, longer life spans and reduced poverty. Inflation was as low as 5% per annum, making these economies safe for investment which resulted in increased foreign reserves. But it only took a little bit of doubt and disbelief that made the situation go awry; as bank runs emerged due to devaluation of Thai Bhath in 1997 which was pegged to US dollar in these economies, causing excessive outflow of foreign capital initiating a severe short term liquidity crunch in Thai economy (Furman et al.,1998; Stiglitz, 2000).

The major reasons listed for Asian crisis was lack of transparency in the domestic financial institutions, liberalization of capital accounts for which financial infrastructure was not available in these economies, sterilization of accounts where, the economy was sterilized of foreign currency and interest rates surged making international borrowing more attractive. Increased interest rates and devaluation of the currency made banks insolvent; the loans advanced were in domestic currency and borrowing was in US $ shrinking its asset side and increasing its liabilities. This resulted in mismatch between lending and borrowing of the banking system (Regnier, 2017).

In 2007- 2008; US Subprime Mortgage crisis collapsed the entire financial system of US. The financial crisis made the world ponder on idea of "too big to fail"(Hellwig, 2009; Demirgüç-Kunt and Huizinga, 2013). Multiple financial institutes such as commercial banks, investment banks, insurance companies that are considered strong pillars of US financial system were part of the crisis that bought the entire system to halt once it crashed (Mishkin, 2011). After the Dot com bubble in 1999, economy was in recession and the interest rates declined in US; investors started looking for different avenues to invest. Mortgage backed securities was one such avenue that seemed lucrative to investors. The investment banks (Lehman Brothers) issued agency rated CDO's (collateral debt obligation) securities to masses which were backed by mortgage houses, making them lucrative investment opportunity. Money for CDO's was being paid by the home owners to investment banks. In order to cover risk of default these CDO's were insured by insurance companies through CDS (Credit Default Swaps) issued by big insurance companies such as AIG. (Demyanyk and Van Hemert, 2009).

The problem initiated when the investors started lending out mortgages to people who had high chances of defaulting. As the defaulters increased in number so does the tangible assets on banks' balance sheet in form of houses (Shiller, 2012). To liquidate and fulfill their obligations to other investors; banks put those houses on market increasing their supply hence reducing its prices. This caused a chain reaction from those people who had mortgage houses and were paying high premiums to abandon their investments as well. As the claims on insurance companies increased and failure to fulfill those obligations lead them to announce bankruptcy in 2008. Later AIG was bailed out by government whereas Lehman Brothers was left out to fail; such bail outs create issues of moral hazard and pass on the burden to tax payers of the society to save failing institutions (Ayotte and Skeel, 2009; Fosberg, 2012).

After the global crisis of 2007-2008; Europe was hit by sovereign debt crisis in 2009 causing disruptions in European economies as well in the entire world. Greece, Ireland, Portugal, Spain and Cyprus were unable to pay back their sovereign debt and third party interference such that of IMF (International Monetary Fund), ECB (European Central Bank) and EC (European Commission) were required to bail them out (Mink and De Han, 2013). Major causes of crisis included political instability, property growth crisis and banking crisis (Lane, 2012). The European economies cannot manipulate their monetary policy as there is same currency for multiple nations hence depreciation was not an option for them. The economies were left with fiscal policy changes with changes in government spending and austerity drive measures to curtail the effects of the crisis (Karanikolos et al., 2013).

3. Who saves the day? The Role of IMF and World Bank

Whenever there has been crisis; IMF and World Bank; the brain child of Bretton Woods financial architecture; have been there to bail out countries in their hour of need (Einhorn, 2001; Ruger, 2005). IMF known as International Monetary Fund provides fund to correct current account deficit of the countries by granting loans and implying structural adjustment programs in the borrowing economies (Williamson, 2000). On the other hand, World Bank has its creed mission to eradicate poverty from the world; its role has rather evolved over time including emergency lending, economic management, peace keeping and providing funds to cure disease like AIDS (Mason and Asher, 2010). The core reason of existence for both the institutions was to keep war at bay and to promote global financial stability using public loans for economic and infrastructural development (Woods, 2006).

3.1 World Bank and World Financial Crisis

With financial crisis emerging on various occasions across time in history, Bank has learnt its lesson and has subsequently focused on policy to encourage growth and stability in the economies in long run. The crisis of Africa led to conclusion that bank needs to develop strong institutions of government, more human resource and participation from poor countries in making policy (Herbst,1990).

In Latin American crisis; Bank set its trail for "structural adjustment" lending where loans were rolled over on the promise of local government for reforms such as trade liberalization, tax reform, privatization and liberalization of capital accounts. With having success in case of Latin America and other economies who followed the prescribed program in 1990's Bank shifted its focus on building human capital, technology and environmental sustainability in the developing countries. All was good until in 1997, East Asian economies were hit with financial crisis; this led to change in the Banks policy towards understanding the dynamics of liberalization of capital accounts (Kaminsky and Reinhart, 1998). Accompanying these; the establishment of UN millennial goals in 1999 was also added to World Banks agenda, leading it to have rather unachievable vision instead of operational mission as there were too many constituencies that were involved in its agenda (Toye, Harrigan and Mosley, 2013).

On the contrary, a vast literature exists critiquing the policies and actions taken by World Bank in crisis management and development in developing economies (Dreher and Sturm, 2012). As under Mc Namara presidency; World Bank majorly failed in reducing poverty and develop infrastructure in developing countries; reasons attributed to only focusing on quantifiable indicators; no corporation with local bodies and moving large amount of money (McNamara, 1981). The major criticism for Bank's activities is on the fact that despite of having structural adjustments people in developing nations are still marginalized; having poor standard of living, poor health conditions, lack of basic infrastructure (George and Sabelli, 1994). The conditions in developing countries shows that despite having high employment rates the people living in these countries are still poor, majorly due to the lack of job security, availability of jobs, harsh working conditions, limited salary and gender biases (Fields, 2015). Issue lies at the part of implementation of the prescribed policy, with less accountability and transparency World Bank has been unable to bear fruitful results (Basley, 2017).

Another important criticism for World Bank has been on governance, where the under developed countries remain under represented and the dictation mostly coming from the Western economies with their personal vested interests. Structural adjustment programs with attached conditionalities initiated by World Bank have been under scrutiny due to the neo liberal policies on borrowing countries also known as "one size fits all" policy of lending; where same conditions and prescription is advised to all nations in need for help from (Bank et al., 2015). This is instated in "Washington Consensus" which recommends far reaching deregulation of financial system, privatization, liberalization to currency devaluations and austerity drives for the borrowing nations (Williamson, 1993). These policies are highly criticized for not only producing detrimental effects on environment, but destroying social fabric, culture, growth and political setup of the recipient countries (Stiglitz, 2002).

3.2 IMF and World Financial Crisis

IMF was founded in 1945 to correct short term current account or trade deficit of the economies, but with time the role of IMF has evolved as to now it establishes structural and institutional reforms just like World Bank for the economies that borrow money as loan (Feldstein, 1998). IMF objective shifted from maintenance of stable exchange rates to stable economic and financial conditions in borrowing nations (Eichengreen and Woods, 2016) which in turn provides opportunity for maintaining cross border exchange and cooperation among nations. Primarily IMF is a multilateral organization which engages in financial and monetary concerns of nations via surveillance, capacity development and lending activities. Latin America, East Asian Economies, European economies call for not being able to meet their debt obligation instigated crisis in those regions, causing IMF to intervene with the bailout package acting as quasi Lender of the Last Resort (Meltzer, 2003; Reinhart and Trebesch, 2016). Those loans provided much needed breathing space for borrowing nations by providing liquidity; but came with certain set of conditionalities such as to reduce government expenditures, increase tax base, reduce subsidy, devaluation of currency, increased exports and reduced imports to restore economic growth (Stiglitz, 1998). IMF places these restrictions to ensure that the countries can reduce their deficit and will be able to pay back the loans that they acquired, by doing so the role of IMF changes from providing short term liquidity relief to managing long term structural changes and spending in economic instructions in the borrowing countries (Kentikelenis, Stubbs and King, 2014).

It should be clear that the prescription that worked in Latin America may not work in Asian economies as the reason for debt crisis is different, financial institution infrastructure is different. In East Asian crisis, the economies just wanted maturity extension so that they can meet their obligation instead IMF came up with $57 million bailout package with fundamental overhaul of the Korean economy that aggravated the overall crisis situation.

The economy just needed to persuade creditors to continue lending by rolling over the existing loans as they come due and such shortages are just temporary. The instance further emphasize on biggest criticism for both IMF and World Bank; "one size fits all" policy (Davies and Schlitzer, 2008). Furthermore, such bailout causes problem of moral hazard as well; Greece is one example that has been bailed out by IMF on multiple instances causing other economies to take excessive risk with the assumption in mind that IMF will be there to bail them out of the crisis (Corsetti, Guimaraes and Roubini, 2006). The role of IMF should be rather more of monitoring in nature rather than overhauling the entire economic structure of the economies.

3.3 Role of Fed in Global Financial Crisis

Role of Fed/ state bank has been an important one, in the situation of crisis and also otherwise in regulating the financial system domestically which have a ripple effect on the global financial system stability (Obstfeld and Rogoff, 2009). Examples of their importance are evident in the US crisis of 2008-09 and Greek debt crisis of 2012. After the crisis of US and Greek , Fed and Bank of England adopted for expansionary monetary policy by keeping interest rates low (Gertler and Karadi, 2011).European banks were more conservative initially when hit by 2008 crisis but adopted for expansionary policy when Greek crisis emerged whereas Fed was rather less conservative and provided liquidity to the banks in need. The fear was of high inflationary pressures, but both economies had low inflation rates despite increased money supply by Fed (Adrian and Shin, 2009). The reason was that the crisis situation emerged as liquidity dried up among the financial institutions because of bank runs so liquidity injected by Fed remained with banks increasing their reserves and not being transferred into economy in form of lending keeping the money supply at the moderate levels (Cukierman, 2013). Furthermore the Fed needs to be vigilant in leaning against the bubbles that emerge in financial markets. Era of over optimism is followed by depression, hence they need to analyze ex ante the bubbles that will produce detrimental effects and make sure the bubble do not grow big causing disruptions in functioning of financial system later on (Foster and Magdoff, 2009). But a major concern here arises in form of moral hazard and passing the burden on taxpayers to save the systemically important financial institutions (SIFI's). Government bailouts happen by using tax payers money and when there is an option available; that Fed will bail out the financial institutions when in crisis such as evident in case of AIG, Bear Stearns, Fannie Mad and Freddie Mac, the financial institutions start taking high risks (Poole, 2009). But this idea was shattered by the fact that Fed let Lehman Brother fail, leading to worldwide crisis situation. This practice for the first time highlighted that “a black swan of no bailout” exists (Taleb, 2007).

4. Becoming Resilient: What needs to be done?

The above stated context of financial crisis and role of global institutions such as World Bank and IMF have set the ground to establish importance of resilience of financial institutions within themselves. Being a resilient financial institution refers to the ability of the financial intermediary to bounce back quickly from the crisis situation. History has proved that crisis are inevitable in global financial systems (Reinhart and Rogoff, 2015; Stiglitz, 2000), but the institutions within the systems can take measures to become more resilient and stable during and after the time of crisis. After the global financial crisis of 2007- 2008 many reforms have been introduced in the banking sector, including more prudent rules and regulations regarding governing, monitoring and regulating this financial institution (Reinhart and Rogoff, 2009; Crotty, 2009). Following are a few recommendations for how to make the financial institutions more resilient in today's global financial systems. It discusses how firms can become resilient internally and what role should be there of the international lending institutions such as IMF, G10 and World Bank.

4.1 Uniformity in the Functions

Global financial system should take a functional perspective for better functioning as financial institutions vary in size, culture, complexity and technology background, but the functions they perform are rather similar and more stable (Merton, 1995; Merton and Bodie, 2006). The institution and system level perspective provides us with static view whereas in today's time we need dynamic view which is possible through analyzing banks functions, (Allen and Santomero, 1997). Furthermore it will allow banks to rather provide customized solutions to varied customers needs such as household, firms and other institutions more conveniently.

4.2 Governance, Supervisory, Monitoring Controls and Systemic Risk

Monitoring, regulatory and supervisory regulations are one important facet of making institutions resilient and increasing bank's efficiency (Barth et al., 2013). The author presents the ideas from the lens of public and private interest focusing on problem of moral hazard and complex structures of banking sector. Results illustrate that tighter controls on banks results in reduced bank efficiency while tight capital requirement results in marginally better efficiency, note that these two there to impede risk of the bank. Countries with independent supervisory authorities increased the efficiency of the institution whereas monitoring in terms of external audits and transparency enhances banks stability. Supervisory controls and monitoring are positively associated with bank efficiency.

Timely intervention in unhealthy financial institutions (whose Non Performing Loans are high) by the supervisory authorities is important which can help in reducing crisis situation in future (Summers, 2000). Such timely intervention helps in determining health of SIFI's as well ensuring that debacle like Lehman Brother 2008 does not happen again. Furthermore monitoring controls including capital, assets, management, earnings, liquidity and sensitivity (CAMELS Framework) analysis of all important financial institutions must be analyzed, to ensure whether the institutions are fulfilling all requirements of the Fed such as Capital Adequacy Ratio etc. This is also known as "offsite surveillance" which can highlight the symptoms of a failing financial institution and provide assistance in providing timely intervention in them and helps them recover (Dash and Das, 2009). After Lehman Brother collapse in 2008, another important guideline to ensure better supervision and monitoring of the financial institutions is BASEL III Accord. The BASEL Accord focuses on capital adequacy requirement, management and risk taking practices of the banks (Jiménez-Martín et al., 2009). Many countries have adopted this regulatory framework to ensure soundness of their financial institutions.

Another important aspect in financial crisis is the systemic risk. The risk is not uniform across various financial institutions that are diverse in their size, nature and complexity hence single measure for systemic risk is not possible. To achieve stability rules and minimum standards should not be different across nationality of the bank; some consistency needs to be there to make it an equal playing field (Ellis et al., 2014). There are four ways to enhance banks governance and to reduce systemic risk. First regulatory capital base of the banks should be increased, second reforms in incentive structures of the managers (paying them in long term debt rather than in equity or cash), third efforts should be made to put reforms of bailing in for creditors in hour of crisis and lastly extending rights beyond shareholders of the institutions to better align their goals with societal needs. (Capiro and Honohan, 2005).

4.3 From Limited Liability to Risk Sharing

After evaluating multiple options such as lender of the last resort, G7 countries, it has been proposed that with the imperative of equity and direct investment initiative; problem of limited liability can be reduced, allowing risk sharing and resulting in high growth and efficient allocation of investment (Rogoff, 1999). This will also reduce the problem of moral hazard and reduce banks tendency to take excessive risk that ultimately becomes the reason for crisis. Another possibility to avoid moral hazard problems and reducing risk taking behavior by the firms is by introducing the concept of "bail in" rather than "bail outs", that includes effort from all the concerned stakeholders internal to the financial institution to provide relief in times of crisis rather than transferring the pressure to tax payers. (Eichengreen and Ruehl, 2001).

4.4 Multilateral Organizations

On the part of multilateral organization such as IMF and World Bank; the idea should be focused on monitoring and facilitating the domestic governments rather than overhauling the entire system (Thacker, 1999). IMF should help the countries in crisis to overcome their liquidity crisis and oversee the operations in legal, political and infrastructural departments whereas World Bank should work on the long term agenda of building sustainable economies for future (Woodroffe and Ellis-Jones, 2000). The lenders should keep a keen eye on the legal system of the countries and the level of transparency in the financial markets. IMF and World Bank can ensure that corruption in the borrowing countries to be put to halt by having more objective measures that will allow transparency in their operations and ensure the aid is used at the right place for intended purpose.

Measures include, global corruption indices, transparency of donor and recipient countries, performance based lending, domestic institutional development, involving local governments in projects and realigning their focus from anti corruption to effectiveness of the aid (Quibria, 2017).

These big institutions should ensure that if the countries want to draw money from the lenders they need to establish their institutions at domestic level (Feldstein, 1998; Drazen, 2002). The conditions to develop the domestic financial institutions and infrastructure will have benefits of multifold. First, the economies will become self sufficient and resilient to face financial shocks. Secondly, it will increase the confidence of the domestic investor or saver in the local banking system which will help in reducing capital flight as it is clear that ratio of offshore accounts is higher in lower income countries as compared to high or middle income country (Bird and Rowlands, 2001). To ensure that poverty is reduced and employment opportunities increase in the economy lending institutions must ensure policies instigating economic growth and international trade; keeping in mind the local industry. Along with this private sector development and increasing self employment opportunities in these economies can bring a major change. Ensuring local government provide better working conditions, more vocational training, labor friendly laws, infrastructure and tools to start up new businesses and availability of cheap capital can enhance the growth prospects in such economies (Fields, 2015)

Furthermore in the time of crisis, procyclicality in terms of availability of the credit has been witnessed in many economies; where these multilateral institutions halt the funding for the countries. These institutions must roll over debt to countries in need easing out their financial crunch as lack of credit impedes the economic activity; a loan with stringent conditions may be advanced; providing the financially dried up economy some fuel to run and time to establish its institutions (Vreeland, 2006). The world financial market needs an aggressive financial regulation coordinated across national markets and nationalization of financial intuitions wherever possible. The new system must create smaller financial systems that can perform basic productive services that the real economy requires, sharply curtailing high leveraged activities from the economy. This change is possible when our theory meets practice and our political reforms are in place as much as our economic.

5. Future of Global Financial Institutions

The dynamic financial markets are ever so expanding, which is providing much lucrative opportunities for investors, reducing transaction costs and making an integrative network of globalized financial institutions. This extensive network comes with its pros and cons. The pros that have been all appalled in literature; the cons have now been receiving much attention after the multiple global crises (Shiller, 2012; Crotty, 2009). Such crisis have highlighted the need for more resilient and stable financial institutions that can survive such shocks and be able to function without putting the entire global system at halt. The emphasis after crisis has been on increasing banks regulatory, supervisory and monitoring roles so that good governance can reduce excessive risk taking and reduce the agency problem (Dash and Das, 2009). Furthermore, highly leveraged firms should be monitored closely in their operations; and risk sharing concept must be introduced in terms of investment in equity so that limited liability and moral hazard problem can be mitigated (Rogoff, 1999). Role of IMF and World Bank is crucial in the time of crisis, both institutions help in bridging the gap for the crisis stricken economies where former focuses on short term liquidity crunch whereas later emphasize of long term sustainability (Woodroffe and Ellis-Jones, 2000).

Having set that, identification of problem is the easy part the hard part is to implement radical changes relating to political, legal and infrastructural development in the crisis stricken economies. This may require geo political intervention and hardcore leadership to ensure transparency and accountability on the part of lending institutions and as well as the borrowing institutions. The important questions that pave their way with the above mentioned discussion entails that, whether current dynamic financial system is sustainable or not? Whether the international bodies such as World Bank, IMF and other G7 countries sufficient to sustain the financial crisis if it emerges again? Are the domestic institutes in the crisis stricken countries developed enough to handle the crisis at their own? This essay tries to provide an overview to the existing literature on managing financial crisis its causes and consequences along with an effort to answer questions stated above. It tries to highlight how different entities involved in the global financial system can comprehend, avoid and mitigate the future crisis situation if one emerges.

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